Quilter

Technical Insights - Quick Reference Guide

Loan trust – Repaying the settlor’s loan

This guide provides an overview of the tax treatment of making repayments of a settlor’s loan to the trust, where the trustees hold an investment bond.

Don’t mix up the mechanics of a loan trust with bond taxation

It’s a common misconception that the repayment of the settlor’s loan is always deemed as return of capital and therefore doesn’t create a tax charge. It is the same misconception that any growth on the loan will always be assessed on the beneficiary as they’re entitled to this. These are incorrect - to understand this, it helps to split the mechanics of the trust from the taxation of bonds.

1. **The mechanics of the trust:** The settlor (the person who created the trust) has made a cash loan. Where the settlor recalls some or all of the loan, the trustees will fund this by surrendering the investments held in the trust in order to make a cash repayment. Once the loan is repaid, any money left is held for the beneficiaries.
2. **Bond taxation:** The taxation of surrenders from investment bonds are governed by chargeable event rules. The amount of taxable gain triggered on the occurrence of a chargeable event will depend on the timing and the method of surrender. Chargeable event rules also govern who will become liable for income tax on the gain.

Selecting a method of surrender

Using the 5% tax deferred allowance

An investment bond allows the trustees to surrender up to 5% of the premium paid each policy year without an immediate tax charge. Unused allowance is rolled forward for future use.

- For a loan trust, this can be useful where the settlor would like to be repaid their loan as a series of regular payments over 20 years or more.
- Where the withdrawal exceeds the available allowance, every £1 over the allowance is £1 of taxable gain. Making this method uneconomic for larger withdrawals - e.g. where the settlor requires full loan repayment before 20 years.

Surrender individual policy segments

Most investment bonds are split into several identical policy segments. Each policy segment carries a share of the bond’s total surrender value. The trustees can surrender a number of these policies to raise enough money to repay the settlor’s loan.

Surrendering policy segments is a chargeable event. The chargeable gain is calculated based on the market value, premiums, and previous withdrawals to reach the ‘economic gain’. This may be useful when surrendering an amount more than the available tax deferred allowance.

Establishing who is taxable for the gain

Chargeable event gains are taxed as income. The person liable for the gain is also dictated by chargeable event rules and will depend on the type of loan trust used.

Bare/Absolute trust - The beneficiary is taxable at their marginal rate.

Discretionary - The settlor is taxable at their marginal rate where the chargeable event occurs during their life time or tax year in which they died. Else, the trust is taxable at the trust rate of income tax (45% where the trust’s total income exceeds a threshold of up to £500). Where there is more than one settlor, apportion the gain between them and consider this rule separately for each.

Calculating the gain

Use our chargeable event hub to calculate the amount of gain and the income tax liability (where either the settlor or beneficiary is liable). ***www.quilter.com/cehub/***

The beneficiary’s share

Which ever method of surrender is used, once the loan is repaid the amount left over represents the ‘growth’ and is held on trust for the beneficiaries. There may be a further chargeable event gain when performing a surrender on the remaining bond.

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